WHY TRUST IS AN ESSENTIAL COMPONENT OF THE SPECTRUM AUCTION

Geoffrey Myers argues that the reputation of the auction regulator can be thought of as ‘essential market infrastructure’

Spectrum auctions can work out broadly as expected, be highly successful, or go embarrassingly wrong. What is often not appreciated is the extent to which the quality of institutions, and especially the reputation of the regulator running the auction, can affect its outcome. Market participants expect an auction to be run with integrity, honesty and fairness.

The regulator’s reputation can, therefore, be seen as part of the market infrastructure for spectrum auctions. This applies in both developing and developed countries, where regulators face different circumstances and are characterised by varying degrees of institutional strength.

The cultural context for auctions is important. In countries with weaker institutions or low levels of trust in public agencies, the regulator can struggle to develop the reputation necessary to hold auctions that are regarded as safe and secure by market participants.

A perceived lack of competence, trustworthiness, rule-keeping, professionalism or integrity can all erode confidence in the auction. The regulator’s reputation can also affect the way the auction is run operationally.

It may require simpler rules, additional independent verification, or the introduction of specific procedures such as safeguards for handling large sums of money.
Reputation and the trust of market participants can also limit the choice of auction design. For example, final prices in the Combinatorial Clock Auction (CCA) format are set by the highest losing bids, a second-price rule. In economic theory this rule has attractive properties of encouraging straightforward bidding, because operators shading their bids below their full value only reduce their chances of winning without affecting prices.

But concern about whether the auctioneer can be trusted to stick to the rules is one reason why this pricing rule is less commonly observed.

These problems can be mitigated if institutions assign importance to their own reputation. A regulator running a series of auctions should appreciate the (potentially irreversible) reputational damage that could be caused by failing to follow its own rules. To enhance trustworthiness, spectrum auctions are often run by independent regulators, at arm’s length from politically controlled ministries, and with their own statutory duties and access to funding. These institutions can prioritise trustworthiness and transparency as important mechanisms for showing that they are accountable, especially given their lack of direct democratic legitimacy.

However, running a CCA requires greater trust from auction participants, because a winning bidder does not have transparency about the derivation of the price it is asked to pay.

The price is set by bids made by other bidders, not the winning bidder itself. The auctioneer sees both the winning and highest losing bids, and there is scope for it to exploit this information asymmetry, such as by charging the winner a price well above the highest losing bid (as has been observed in practice in private-sector applications such as auctions of stamps). In practice, second-price auctions are used, including by eBay.

Regulators who have adopted auctions with a second-price rule have generally put in place multiple levels of verification. For example, in the UK’s 2013 auction, the prices were determined by an electronic auction system that had previously been audited by an external consultancy.
They were checked by independent calculations and verified by another external consultancy. In addition, all the losing bids were published after the auction, along with software to allow bidders to satisfy themselves that the rules had been followed. Such mechanisms can enhance perceptions of procedural fairness and build trustworthiness, as well as being inherently valuable.

The reputation of the regulator and the trust of market participants are a key element of the market infrastructure.

The regulator’s attributes can limit or broaden realistic auction design options, such as the feasibility of using a second-price rule. More generally, the efforts of regulators to enhance their trustworthiness will be rewarded with more successful spectrum auction outcomes.

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His book: Spectrum Auctions: Designing markets to benefit the public, industry and the economy is published by LSE Press and can be downloaded free here.